THE VALUE OF AUDITING TO THE BUSINESS MAN

In the discussion of this subject three questions of a preliminary character require attention:

1. What is the distinction between the bookkeeper and the auditor?

2. Of what does an audit consist?

3. What special knowledge is possessed by the bookkeeper which the auditor does not have?

There are three distinct spheres of action in dealing with accounts: (1) The accountant, whose work is constructive, is the arbiter of methods, who regulates how the work shall be done. (2) The bookkeeper, who follows along the lines laid down for him, and (3) the auditor, who reviews the work, sees that it is properly carried out and certifies to the correctness of the results obtained. These three operations can be the work of one individual, and, though more commonly the bookkeeper occupies a subordinate position, with, in some cases, a professional auditor to supervise him, the number of public accountants who are taking positions, where they really act as head bookkeepers, especially with the larger corporations, is constantly increasing. Such men seldom do any actual bookkeeping work, and often combine the duties of accountant, bookkeeper and auditor. In other words, old distinctions are disappearing, as the science of bookkeeping increases in difficulty and efficiency. As a general proposition, however, the knowledge of bookkeeping, which is the average bookkeeper's only equipment, is but the A B C of the accountant and auditor, and the latter by training and experience must obtain a wider and more general education than the former has opportunity or inducement to attain. It is most necessary for the auditor to instruct himself in finance and law. He need not know as much of these subjects as the banker or lawyer, but he must have the faculty which they need not possess of interpreting what they have in mind into proper form in his accounts. With the growing complexity of the organization of large corporations, this knowledge increases both in value and difficulty.

and the accountant in active practice does not know from day to day what novel problem he may be called on to solve.

Leaving out of consideration, however, the more complex questions which may confront him, the accountant or auditor is constantly called on to undertake work in businesses with which he has had little or no experience. From this fact arises frequent skepticism as to the value of the public accountant's services. Business men who would not hesitate to consult their lawyer on any question of law, often appear unable to understand that the public accountant stands on precisely the same ground as the lawyer, and consequently will frequently trust to the more limited judgment of a bookkeeper who has had experience in a similar line of business. No doubt this hesitation generally arises from the fact that accountancy in its higher grades is a profession that has only recently come into notice in this country, but it is also due to the lack of a proper appreciation of the scope of its utility.

The science of double-entry accounts rests on the simplest of axioms, and that is every debit must have its corresponding credit. In that one sentence is summed up all that it is necessary for the bookkeeper to know. The carrying out of this simple rule, however, leads to almost unlimited variations, which may be highly complex in character, and it is on the intelligent handling of the figures taken from a set of double-entry books that the value of a statement of the accounts depends. In doing his work, the accountant is guided by certain basic principles, some of which are common to all classes, and others to certain sections, of the whole field of accounts. Certain conditions which apply to one business are common to others, which may be entirely dissimilar in many of their details, and it is on the power to adjust his experience to fit unfamiliar conditions that the accountant must mainly depend. Under such circumstances, the bookkeeper's acquaintance with details may be considerably more extensive than the auditor's, and it is at times well for the latter that this is the case. The value of his services arises from the fact that he brings to his work a knowledge specialized to an extent which the bookkeeper seldom has opportunity to acquire. It is hardly too much to say that the accountant need not be a bookkeeper at all, but this is as true as is the fact that the most brilliant lawyer may not be able to draw up an affidavit as well as his clerk can.

To give a concise definition of an audit is not an easy matter. Its variations are almost unlimited, and its exact significance depends on the determination of the auditor's responsibilities. The actual details of an audit and the responsibilities depend on the *raison d'être* of the audit itself. It may consist simply of the checking of a well designed set of accounts in a business having no complex features; in other cases, the exact reverse may obtain. Or, the auditor's services may be required on an examination for the purpose of the purchase, sale, or incorporation of a business, or an investigation occasioned by fraud, diminishing profits, threatened bankruptcy, or a variety of other causes. As a rule, however, as already shown, the term audit is generally used to cover a simple checking of accounts to prove their correctness, and a distinction is made between such work and investigations or examinations for any purpose. All these classes, however, come within the auditor's duties. The object in every case is to certify to the correctness or falsity of the figures as shown on the books, but this cannot be given as a definition of the word audit.

Some qualifications on this are necessary. For example, a set of figures might be absolutely correct, as shown by the books, but in the case of an incorporated company, the figures might contain items which should never have appeared. A case within the writer's experience illustrates this fact. In the course of an audit, it was discovered that not only had none of the dividends paid been legally declared, but that the company had never legally come into existence, and even if it had, at the time of the audit, it had no lawfully constituted officers. This condition, however, had not prevented the concern from earning and paying dividends of 2 per cent a month for a matter of nearly three years. Fortunately, the corporation was a close one, all the shareholders being near relatives, so that it was possible to rectify the mistakes without much trouble.

The errors which it is the auditor's business to detect may be classified as follows: (1) Errors of principle, (2) errors of omission, (3) errors of fraud. Examples which may be suggested by these errors are:

a. The inclusion in the revenue accounts of profits which are not available for distribution;

b. The failure to make provision for invisible wastes or losses;

c. The omissions of liabilities in drawing up a balance sheet.

The first is an example of an error of principle; the other two are errors of both principle and omission, and often all three are errors prompted by the desire to deceive, even if they are not founded on actual fraud.

It is an axiom of accounts that a profit is not earned until its receipt is actual or is reasonably assured. An illustration of this is the usual practice of treating interest and dividends receivable. It is customary to include interest accrued on first-class bonds in the accounts as the amount is certain and its receipt is reasonably sure. Dividends on stocks, on the other hand, are not credited up until they are declared, for their amount is uncertain, and there is no assurance that anything will be distributed.

The most common method of bringing unavailable profits into the revenue accounts is to increase the cost price of inventory items, or to raise the book value of real estate, securities owned, or some similar asset. In each of these cases the increase in value may be actual, and often the action may be prompted by a perfectly innocent desire to make a good showing. The test of the legitimacy of such profits is, can they be distributed if brought into account? And, in each of the cases in point, this can be made possible only by the sale of property in question. Where inventory items are concerned, this is likely to happen in the near future, and so the bringing of such profits into the account may result only in the anticipation of a reasonably certain gain. Some years ago, in the English courts, the present Lord Chief Justice, then Sir Richard Webster, advanced the ingenious argument that such profits were not profits of selling, but profits of buying, and therefore it was perfectly legitimate to take all inventory items at market instead of at cost price. The objection to such a claim is that there is no certainty that the market may not have declined, even to a point below the purchase price, by the time a sale is consummated.

The increase in the book value of real estate, securities or other similar assets, stands on an entirely distinct basis. Such properties are, in the case of any ordinary business, usually acquired because they are necessary to its proper conduct, and their sale would mean the loss of certain advantages, if it did not result in the extinction of the business itself. There is, therefore, no possibility of realizing the necessary cash on this class of profits, and their distribution can be made only at the expense of the working

capital. In other words, any dividends from such a source can be paid only out of funds which are required for other purposes. In dealing with this subject, only the payment of cash dividends has been considered; the question of stock dividends being ignored. If, however, an increase in the stock, to offset the increased value in assets, is justifiable, and such is often the case, the profit so brought into account should not be merged with the ordinary revenue, but should be stated separately and distinctly.

The most common and effective method of detecting such errors, as are outlined above, is to draw up comparative statements of accounts, at the beginning of the period under review, placing in a parallel column the figures at the end of the period and setting up and examining the various changes. By this means a comprehensive view of the course of the business is obtainable and attention is drawn to any suspicious looking items. A heavy decrease in the current assets which was not neutralized by a similar condition in the current liabilities, would challenge inquiry, especially if it was accomplished by an increase in plant or some other fixed asset. By treating the inventory in a similar manner, large fluctuations would stand out prominently and deliberate padding, if extensive enough to be of consequence, should be detected.

Other methods of padding the revenue accounts are the taking in, as finished, work on which large expenditures are still required, or the inclusion of the total amount of a sale of a lease, or more than the proper proportion of a contract having a number of years to run. The writer, a few years ago, encountered instances of both of these methods. In the first, a company had contracted to perform certain services for a term of ten years; they had been paid the full amount, but had done only one year's work. This fact, however, did not prevent them from taking the entire sum they had received into their profits. Exactly similar cases are not common, for it is unusual for such lump payments to be made, but cases where profits on contracts have been taken in excess of the proportion the finished work bears to the whole, are not at all unusual and are oftentimes very hard to detect. In the other case mentioned, a company had leased a part of their property for a term of years, the rental to be paid annually. An examination of their profit and loss account showed that they had included the whole amount, such a matter as deferred payments apparently being con-

sidered of no consequence. This again was unusual, but it furnishes an illustration of the extraordinary efforts to make a good showing which may be met with.

The failure to make provision for invisible wastes, or losses, generally takes the form of the omission of any provision for depreciation, or bad debts. It is as sensible to omit part of the cost of the raw material in a manufactured article as to fail to take account of that part of a machine's life which is consumed in the making. There lately appeared, in a much-advertised guide for accounting students, the statement that there was no need to charge off any depreciation as long as a machine was doing as good work as was possible, and that it was by no means uncommon in mining districts to find engines which had been in use for fifty years and were just as good as ever. Every accountant comes across cases of unusual survival on the part of machinery. The writer once met with a printing press of this description. Its owner cited it as a proof of the folly of making any allowance for depreciation. He claimed, with what truth cannot be told, that it was forty years old, it certainly looked it. He betrayed his case, however, by stating that it was one of an original plant of ten presses installed when the business started. Its companions had long gone to the scrap heap, and the survivor was, by its owner's confession, only capable of the roughest kind of work. But he triumphantly claimed it would do *that* as well as a brand new press.

The man who will not allow for depreciation will be always with us, and so unfortunately will the man who insists on writing off too much. The latter is really far more difficult to deal with, as his plea is that he does not want to be fooled by an overestimate of his assets, and wants to have something in hand for hard times. It is certainly exasperating for the auditor who wishes to do more than show the bare amount of the profits, to be confronted with a plant account which has been written down to one dollar or some inadequate figure. The value of a comparison between the profits of different periods is, of course, destroyed, and very often no possibility of estimating the future course of the business remains.

A favorite question with the examiners for accountancy degrees is: How can the auditor be certain that all the liabilities are disclosed on the books? An auditor cannot be absolutely certain on this point. There are, of course, certain features to look out for and

certain precautions which can be taken. Accrued charges of any kind, naturally occur as the most common errors of omission, and the obtaining of statements from all the creditors on the books is a precaution sometimes resorted to, but when every care along such lines has been taken, there still remains a large opportunity for failure to get all liabilities on to the balance sheet. An examination of the inventory and of the invoices passed directly after the close of the fiscal period, will often bring to light many omissions but the deliberate holding back of large expense items, for example, a heavy lawyer's bill, or a judgment for damages, may in the absence of any evidence of its existence, foil the most careful auditor.

Deliberate errors of fraud on a large scale are fortunately rare, when the volume of business is taken into account, and when they occur are more generally found outside of what can strictly be described as bookkeeping. In the small, much-advertised companies which are constantly being ground out, to catch the unwary, however, errors of accounting which it is charitable to suppose are made in ignorance continually occur. The most common of these is the custom of counting as profits the proceeds of the shares sold to the public. The method used is as follows: A property of the agreed value, say $100,000, is purchased from the vendor for $1,000,000. The vendor then returns $900,000 in shares to the treasury of the company. In this way the shares have been issued fully paid and non-assessable, and the property stands in the books at $1,000,000. The public are then offered shares worth $1 fully paid, etc., etc., for the trifling sum of five cents,—all subscriptions received are reckoned as profits, and if the demand is brisk, the price is rapidly advanced and larger and larger dividends declared. This continues until the shareholders discover that they have been paying office rent, salaries, and advertising for the privilege of receiving as dividends a moiety of the capital which they have invested. If they get off at that, they are fortunate, for many such schemes have little to distinguish them from the "get-rich-quick" frauds, except greater difficulty in bringing their promoters to book.

While frauds on a large scale are comparatively rare, embezzlement by employees, which are covered up by falsification of the books, are unfortunately only too common, and the exposure of the culprits forms one of the most disagreeable of the accountant's

duties. No rule can be laid down for the detection of errors of this kind, except the exercise of extreme care. The greatest difficulty often is, to catch the end of the thread, and to grasp the methods by which the embezzlement is concealed. The writer once had a case, where the first clue he obtained that anything was wrong, was the fact that a cheque for the petty sum of $1.65 was offered as a receipt. It can only be supposed that this was a slip due to the necessity of producing a balance in a hurry, for the culprit was an expert book-keeper, but it was one of the slips that almost invariably occur in such cases.

We have finally to inquire: How are certain leading accounts usually audited? The following have been selected for study: (*a*) Credit sales; (*b*) accounts and bills receivable; (*c*) depreciation; (*d*) surplus.

To make sure of the correctness of the sales as stated in the books, is only possible in an audit of a small business, for it necessitates the checking of every shipment or delivery made. This is, of course, impossible in the case of a large concern, and if the accounts will stand a certain amount of testing, they are generally assumed by the auditor to be correct. How these tests are to be applied and the extent of their probable accuracy, depends largely upon the comparative perfection of the accounts to which they are applied. Where a continuous inventory is kept, the check can be made much more efficient than where this is not the case. Perhaps the easiest business to check up closely in this respect is in the jewelry trade, for although the value of the gems contained in the inventory can only be appraised by experts, at least the more important items appear in the books under certain well-defined numbers, and it is a comparatively easy matter to trace them if necessary. Each class of stone has its distinct number; diamonds or packets of diamonds in the case of small stones may be numbered from one to five hundred; pearls from five hundred to one thousand and so on, so that with reasonable care every sale can be verified. In the general run of businesses, however, no such thorough check is possible, and the auditor must depend on comparison between periods, and on the exercise of ceaseless vigilance to save him from a false step. Details which demand especial attention, are the charging up of packages which will be allowed for on return, and the provision for returns and allowances.

It should be possible, as a rule, to make sure of the value of bills receivable, as they are limited in number. They should be listed, those which are overdue noted, and a lookout kept for long-continued renewals and accommodation paper which may be a liability instead of an asset. Accounts receivable, on the other hand, are often so numerous that their close scrutiny is impossible. Where this is the case, a "controlling" account is generally kept. The total of this account should be proved with the summary of the debtors' ledgers, and the provision of an adequate reserve for bad and doubtful debts and returns and allowances should be insisted on. Certain accounts taken at haphazard should be checked and any unusual features noted. It is impossible to lay down any law as to the maximum period of credit that should be allowed before an account is considered doubtful, for a great deal depends on the peculiarities of the trade under review. The indiscriminate charging off accounts receivable is, however, to be deprecated as long as a reserve proportionate to the average loss in prior years is set up. As a matter of fact, the collection of an account is only impossible: (1) When the debtor has received his discharge from the bankruptcy courts. (2) When he is dead and his estate has been administered. (3) When a composition of the debt has been accepted. (4) When he has successfully defended an action brought against him for recovery of the debt. (5) When action is barred by the Statute of Limitations. This does not necessarily mean that all such accounts should be left in the active ledgers, but that the possibility of their recovery should not be lost sight of.

The question of depreciation is one of the most complicated with which the auditor has to deal. As a matter of fact, the adequacy of the allowance made under this head is generally more a question for the engineer than for the accountant. Two considerations must be recognized in dealing with the question: (1) The ultimate expiration of the useful life of the object to be depreciated, which is inevitable; and (2) the chance, especially in the case of machinery or process plants, of its continued use becoming unremunerative on account of more economical methods being discovered, which is very possible. As a rule, the auditor had better confine his attention to an endeavor to have some allowance for depreciation made in the accounts and to seeing that such allowance is made in a form which is likely, to produce satisfactory results.

The three most usual methods of making such an allowance are: (1) By writing off a percentage of the cost each year. (2) By writing off a percentage on the diminishing value. (3) By setting aside a sum which on an annuity basis will return the cost at the expiration of the object's probable life. It is claimed that the last of these methods is the most scientific, but from an accounting point of view this is open to question. The value of any set of accounts is enhanced by the extent to which they make comparisons between different periods possible. It is needless to point out that as a general rule the greater the age of buildings, machinery, etc., the greater is the cost of keeping them in repair. If it is desirable, therefore, to determine the average plant cost of an article produced by any machine, it is necessary to divide the total original cost of the machine, the expenditure on the necessary repairs during its life, less its residual or scrap value, by the total output during its period of production. The result will be the average cost of each unit manufactured. Such a calculation can, of course, only be made after the machine is worn out, but the theory of the question should be borne in mind. Since the necessary repairs must invariably increase as the machine's period of usefulness expires, approximately correct results can be obtained only by decreasing the charge for depreciation as the cost of repairs increases. On this basis, therefore, the second method mentioned is the more commendable.

The subject is far from exhausted, however, even when the problems of dealing with wear and tear are satisfactorily settled. A number of objects subject to depreciation remain, such as patent rights, premiums paid for leases, and allowances for the exhaustion of mineral-bearing land.

As the exact life of any patent right is known, this class would appear to offer few difficulties. It must not be overlooked, however, that the good will created during the protected term may be considerable and may even exceed in value the original cost of the patent itself, or that the term of life of a basic patent may be greatly prolonged by patentable improvements being made, prior to its expiration. The term of a lease determines the amount which must be allowed for its extinction; and in both these cases the annuity basis for figuring depreciation is the most desirable.

The depreciation of mineral-bearing lands can be conveniently illustrated by coal mines. In this case, interest on the investment

should be allowed each year, and an estimated provision per ton of the coal mined should be made to offset cost of the property by the time it is exhausted, plus the interest for the year in which the output was made. Any residual value such land may have must also be taken into account.

A surplus may be defined as the excess value of the assets over the combined liabilities and capital. Where the accounts of an ordinary commercial concern are under consideration, many accountants prefer to call this excess the balance of profit and loss account, general profit and loss account, or some such term, in order to make a distinction between the surplus of a bank or similar institution, and that of other businesses. The accuracy of the surplus must, of course, depend on the accuracy of every other item entering into the balance sheet. If the balance sheet were an absolutely correct statement of conditions at all times, the certainty of the surplus being properly stated would be a simple matter. This, however, is only the case before the ordinary concern has done a stroke of business, or when its affairs have been finally liquidated. Every balance sheet between these periods is, to a greater or less extent, an estimate of the condition of the business. Consequently, the auditing of a surplus consists of carefully gauging the correctness of every other portion of the accounts. Perhaps as good a way as possible of illustrating this, is to take the case of a business which has set aside a certain reserve for some purpose, for a reserve and a surplus have much in common. We will suppose this reserve has been accumulated to provide for new machinery when the old is worn out, and that, as an extra precaution, the cash so set aside has been withdrawn and invested outside the business. The balance sheet might then appear somewhat like the following:

ASSETS.		LIABILITIES.	
Real estate, machinery, etc.	$1,000,000	Capital	$1,250,000
Investments for sinking fund purposes	250,000	Reserve for depreciation of machinery	250,000
Current assets and inventory	850,000	Current liabilities	500,000
		Surplus	100,000
	$2,100,000		$2,100,000

A layman might well hold up such a statement as a model of conservative management. If, however, the auditor on examination found the current assets and inventory contained worthless items

amounting to $500,000—of course, this is stating an extreme case—and an appraisal of the real estate, machinery, etc., showed its true value to be only half what the books stated, he would have to reconsider his opinion in the light of such a statement as this.

ASSETS.		LIABILITIES.	
Real estate, machinery, etc.	$375,000	Capital	$1,250,000
Investments	250,000	Current liabilities	500,000
Current assets and inventory	350,000		
Deficit	775,000		
	$1,750,000		$1,750,000

Such a radical change—no greater than has actually been proven necessary in the cases of many bankrupt corporations—is worth a little consideration. The reserve set aside to provide for depreciation, its inadequacy fully demonstrated, disappears, for a reserve and a deficit would be indeed incongruous neighbors. The sinking fund so conservatively provided for the purchase of new machinery has sunk out of sight, and the cash invested in its securities will barely suffice to restore the equilibrium between the current assets and current liabilities. The company which made so brave a showing on paper remains, its capital impaired over 60 per cent and with a poor $100,000 working capital left, is about ready to join the ranks of those corporations whose reconstruction is so distressing their unfortunate shareholders at the present time.

The services to be rendered by the public accountant are not however confined to the correction of errors and abuses. His training and independent position enable him to suggest improvements in most accounting systems, which probably would not occur to those in charge of the banks. Where his visits are made periodically they are apt to correct that tendency to get into a rut, which is the bookkeeper's most common failing. Ignorance and not fraud is the frequent cause for the failure of firms and corporations, errors which at the beginning would be readily rectified, being allowed to cumulate until their effect is disastrous. Of late years accountancy, as a profession, has materially advanced in proficiency and public esteem. It mainly depends on the business man how rapid the progress is to be in the future and to what extent he is to be benefited both in his personal affairs and in his responsibilities as a corporation director.

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